EQUIUS ASSETCLASS℠

Modern asset class investing principles, research, and perspectives for long-term investors

November 2018

Intelligence Is Not Enough

Jeff Troutner, Equius Partners

It is not enough to have a good mind; the main thing is to use it well.—Rene Descartes

I cringe whenever I hear someone say, "But he/she is soooo smart" or "He/she is so much smarter than so-and-so," as if that's the end of the conversation.

The market is incredibly efficient in how it prices stocks because a lot of smart people trade a lot of stocks for the mutual funds they manage. But only 8% of them have been able to beat a "dumb" index like the S&P 500 over the past 15 years.* Good minds not used well.

A Nobel Prize–winning economist Joseph Stiglitz was a huge fan of Hugo Chavez, who all but destroyed Venezuela's economy. Yet Stiglitz once asked an academic colleague whether Paul Volker (arguably the greatest Federal Reserve chairman in history) "is as smart as us."

I was reminded of this again recently when I read an article about the race for the office of New York state comptroller. As the writer points out, the current comptroller, Tom DiNapoli, has many responsibilities, from auditing state agencies to serving as the state's accountant. But his most important job is as the *sole trustee* of the New York State and Local Retirement System, which has $207 billion in assets and funds the retirement of 1.1 million people.

A complex financial job, right? Well, according to the article, "no comptroller in living memory has had a background in finance," and DiNapoli is no exception. Before he took over the office 11 years ago, he was in the state assembly, and his last private-sector job was 30 years ago when he was a telecommunications manager. Smart, no doubt, but is that enough?

Evidently not. According to Jonathon Trichter, the person who ran against him in the current election cycle, DiNapoli authorized $6 billion in fees to hedge funds, private equity funds, and other "alternative" funds over his tenure (including $818 million in 2017) for subpar performance—5.4% annually on the $35 billion in alternatives versus 7.5% for an S&P 500 index fund. This is an opportunity cost of almost $8 billion on top of the massive fees.

Trichter, on the other hand, has spent a career in finance and was involved in restructuring some of the most mismanaged pension funds in the country (like Jacksonville, Florida's plan). His solution for New York? Get rid of the expensive, underperforming hedge funds, private equity, and other opaque and complex strategies and invest in index funds. A good mind used well? I think so.

But he lost the race. A lifelong member of DiNapoli's political party, Trichter switched parties to run for the comptroller's office so he could institute positive, evidenced-based changes. DiNapoli was not held accountable by voters, nor is he likely to be sued for his obvious disregard for established principles of prudent investing. He clearly cares more about his friends on Wall Street than he does the workers of New York or its taxpayers (who are likely to be the ones who ultimately pay for his gross ignorance).

Unfortunately, this is how most public pension plans are managed today. As a result, after nine years of a powerful up market in stocks, most public pension plans remain grossly underfunded. This will either result in cuts to promised pension distributions for workers or large tax increases to cover the shortfall—or both.

When government officials screw up, they often get reelected or move on to other lucrative careers and we, as taxpayers, pay the price. This is the opposite of progress.

When corporate retirement plan sponsors and trustees ignore the evidence and make expensive mistakes, it's employees, shareholders, and other beneficiaries who pay the price. But these stakeholders are looking increasingly to the courts for appropriate remedies. This appears to be the only way meaningful progress can occur in our industry. Equius has taken steps to become more involved in this effort. Please contact us if you know of a situation where we can help.

---

*S&P Indices Versus Active (SPIVA) report ended June 30, 2018, on the performance of all U.S. large-cap funds.

A Question of Equilibrium

Jim Parker, Dimensional Fund Advisors

"Sellers were out in force on the market today after negative news on the economy." It's a common line in TV finance reports. But have you ever wondered who is buying if so many people are selling?

The notion that sellers can outnumber buyers on down days doesn't make sense. What the newscasters should say is that prices adjusted lower because would-be buyers weren't prepared to pay the former price.

What happens in such a case is either the would-be sellers sit on their shares or prices quickly adjust to the point where supply and demand come into balance and transactions occur at a price that both buyers and sellers find mutually beneficial. Economists refer to this as equilibrium.

But the price at which equilibrium is reached can change. That's because new information is coming into the marketplace continually, forcing would-be sellers and would-be buyers to constantly adjust their expectations.

That new information might be company-specific news on earnings. It might be news that has implications for specific industries—like a spike in oil prices. Or it might be an economic development that affects the entire market, like a change in the unemployment rate. Given this constant flow of news and information and the changing expectations of participants, it can be reassuring to remember that for everyone selling shares there must also be buyers of those shares—or the trades will never take place. And whenever information changes, prices may change and quickly reach a new equilibrium.

Recent trading activity by market participants in shares of a US-based health care provider offers a clear example of how quickly prices adjust to new information. It was reported in late July 2018 that a large private equity firm was in talks to purchase the health care firm at a price valuing the company at $65 per share. Prior to the announcement, shares of the firm were trading around $48. As we see in Exhibit 1, when the announcement broke, the market price for the stock adjusted overnight to just below $65. In other words, after news of the impending sale hit the market, the supply and demand for the stock met at a new equilibrium price.

Given that security prices rise and fall based on a multiplicity of influences, how should investors interpret and act on these signals? We believe that trying to untangle all these influences and profit from perceived mispricing is not possible in a systematic and scalable manner.

An alternative approach is to start by accepting that prices are fair and reflect the collective expectations of market participants. While information frequently changes, this is quickly built into prices. Competition among buyers and sellers is such that it's not possible to consistently outguess the market.

The second step is to see that fairly priced securities can have different expected returns. And we can use market prices and security characteristics to identify those securities that offer higher expected returns.

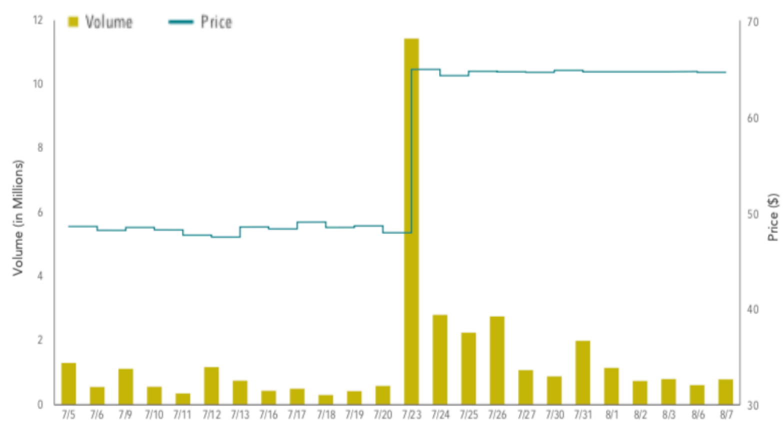
The third step is to build highly diversified portfolios around these broad drivers of return, while implementing efficiently and managing the cost of buying and selling securities.

The final step is to apply discipline and rebalance your portfolio either to stay within your chosen risk parameters or to adjust for changes in circumstances.

Ultimately, the market is like a giant information-processing machine. All the influences mentioned above are constantly being assessed by millions of participants, and prices adjust based on those collective expectations.

The returns we expect from investing do not necessarily show up every day, week, month, or even year. But the longer we stay invested, the more likely we are to capture them. So, rest assured that even when prices are falling, people are still buying. The market is doing its job, and we believe the rewards will be there if you remain disciplined.

Exhibit 1: Price Movement and Daily Volume for Shares of US-Based Health Care Provider; July 5- August 7, 2018



In USD. For illustrative purposes only. Stock price data as shown are official Nasdaq closing prices. Data provided by Bloomberg L.P. See end disclosures for additional important information.